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SUBJECT: FRENCH GDP GROWTH AROUND 2 PERCENT IN 2006

Ref: Paris 3464

¶1. SUMMARY. In its June overview of the French economy, the National Statistics Agency estimated 2006 GDP will increase 2 percent in 2006, the low end of the original government forecast range of 2.0-2.5 percent on which the 2006 budget was based. Any improvement in GDP growth above 2.0 percent largely depends on world economic growth, most notably stronger domestic demand in Germany, France's main trading partner. END SUMMARY

#### Economic Growth in France and the Euro Zone

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¶2. In its June overview of the French economy, the National Statistics Agency (INSEE) noted that the French economy has experienced robust economic growth since summer 2005. The 2.0 percent growth in GDP (annualized) in Q-1 confirmed steady household consumption and a recovery in exports, both of which benefited from a dynamic world economy. Despite increases in oil price prices, inflation remained moderate as price increases did not result in significant wage increases.

¶3. INSEE expects ECB interest rates to rise above 2.75 percent, which would increase long-term interest rates in the euro zone. These potential increases may offset any positive impact of higher domestic demand on economic growth. Demand in the euro zone has risen considerably thanks notably to a recovery in domestic demand in Germany. Taking into account the euro's gains against the US Dollar, INSEE foresees the ECB implementing monetary policies meant to bring economic growth in the euro zone back in line to around 2.1 percent, a pace closer to its long-term trend.

#### French GDP on a 2 percent Trend in 2006

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¶4. In this context, the French economy would increase at a pace close to 2.0 percent in the second half of this year, but would not benefit from "any real acceleration." INSEE predicted GDP to increase 2.0 percent (annualized) in 2006 after 1.2 percent in 2005. GDP, which did increase 2.0 percent in Q-1 (ref), is forecast to increase 2.4 percent in Q-2, and to keep growing at the same pace in Q-3 and Q-4. Growth in the construction and services sectors should offset modest 1 percent growth in the manufacturing sector which is due largely to poor performance in the automobile sector.

¶5. Michel Devilliers, INSEE's chief analyst, emphasized that household consumption seemed to be heading in the right direction. Consumption of manufactured products did well in April and May, this due in part to the soccer World Cup. INSEE predicted household consumption to increase 2.6 percent thanks to a 2.4 percent increase in purchasing power. That increase reflects moderate inflation (1.8 percent in December over December 2005) and a decrease in the

unemployment rate from 9.3 percent in April to 9.0 percent in December, close to the government goal of 8.9 percent. INSEE expects the labor situation to improve not only because of a shrinking labor force and an increase in government-subsidized employment contracts, but also due to job creation in the private sector (20,000 jobs per quarter). INSEE estimated that a total of 196,000 jobs will be created in 2006, including 75,000 jobs in the private sector. This figure is considerably higher than the 99,000 jobs created in 2005, with only 63,000 jobs in the private sector.

¶6. INSEE forecast a 7.4 percent rebound in exports and a 10.5 percent increase in exports of manufactured products, again due to strong foreign demand, notably from Germany, France's main trading partner. When asked whether it would be preferable to have France or Germany win the World Cup, INSEE said it would prefer Germany because of the positive impact a victory would have on consumer confidence and domestic demand in the country, directly affecting French exports. According to Devilliers, increased consumption in France was related first to an increase in purchasing power and not household confidence, which he deemed reassuring.

¶7. Even so, export growth would be insufficient to significantly boost corporate investment. INSEE forecast corporate investment to pick up in Q-2, increasing to 3.8 percent in 2006; this would mirror 2005 numbers but remain below levels normally seen in a period of economic recovery. Corporate margins as a percent of value added are likely to deteriorate as productivity gains would increase less than labor costs.

#### Mixed Risks

¶8. INSEE's estimates are based on oil prices at 70USD per barrel and a Euro/US Dollar exchange rate at 1.27. INSEE saw a possible

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decrease in the US Dollar against the euro, which could occur should U.S. budget and current account deficits sink further into the red, as a major risk. Increases in the prices of raw materials could also create fears about the resurgence of inflation. On a positive note, INSEE did not exclude the possibility that a surge in the world economy in the very short-term could give some dynamic economic growth in the euro zone, including France.

#### Comment

¶9. France does not seem to benefit fully from world economic growth. INSEE's 2006 GDP growth forecast is at the low end of the government's original estimates, ranging from 2.0-2.5 percent for 2006. This discrepancy may fuel questions about the accuracy of government estimates, especially since Parliamentary deputies started on June 22 to debate the broader aspects of the 2007 budget.

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